

## 4.4 The role of international trade

### Learning Outcomes

- With reference to specific examples, explain how the following factors are barriers to development for economically less developed countries:
  - a) Over-specialization on a narrow range of products.
  - b) Price **volatility** of primary products.
  - c) Inability to access international markets.
- With reference to specific examples, explain how long-term changes in the terms of trade is a barrier to development for economically less developed countries. (HL)
- With reference to specific examples, evaluate each of the following as a means of achieving economic growth and economic development:
  - a) Import substitution.
  - b) Export promotion.
  - c) Trade liberalization.
  - d) The role of the WTO.
  - e) Bilateral and regional preferential trade agreements.

### Glossary

**volatile** liable to change rapidly and unpredictably

### Subject vocabulary

**primary goods** a good that has not been processed and is in a raw state (e.g. fruit/wheat)

**export revenue** income that flows into a country from the rest of the world from the sale of its goods and services to foreign buyers

**terms of trade** the amount of imported goods a country can buy per unit of its exported goods

**dump** the export by a country or firms of goods at a price that is lower than the cost of production

**excess supply** occurs when quantity supplied is greater than quantity demanded

**resources** the inputs into the production process, the factors of production

**price inelastic** the percentage change in quantity demanded/supplied < the percentage change in price

### Synonyms

**deterioration** ..... weakening/decline

Discussed below are some of the factors that act as barriers to economic development in LDCs.

### Why does over-specialization act as a barrier to economic development?

**Model sentence:** An LDC is dependent on the production of **primary goods**, making the country dependent on a limited number of goods for its **export revenue**, with which it can buy the imports it needs.

Over-specialization on a narrow range of goods means a country can be badly affected by changes in the relative prices of exports and imports. If the world price of the main export falls the **terms of trade** deteriorate. As industries become more productive, world supply increases – pushing long-term prices down – therefore the terms of trade of primary goods falls over time. Fewer imports can be bought with the revenue earned from a given quantity of exports.

**Model sentence:** As the world supply of primary goods increases and their price falls, an increasing quantity of agricultural or mineral output will be needed to pay for imported manufactured goods.

If a country does not increase the range of goods it produces the falling price of primary goods will lead to increases in poverty.

In order to increase export revenues, by meeting the increasing demand for primary goods in the developed world, LDCs use up their non-renewable resources, thereby reducing the opportunities for future generations to earn income. Some primary products will eventually run out, so economic development will be negatively affected if it does not increase the variety of goods produced. A country that is over-dependent on a narrow range of goods tends to concentrate most of its investment in those industries, leaving very little left for investment in industrialization, education, and health which would improve economic development in the long term.

Agricultural output, unlike manufactured goods produced in developed countries, is affected by changes in weather conditions. Supply, and therefore revenue earned, varies over short time periods. Developed countries also **dump** their **excess supply** at below cost prices, leaving the domestic suppliers in LDCs unable to compete.

### Why does the price volatility of primary goods affect economic development?

As explained above, over-dependence on a primary good leads to **deterioration** in the terms of trade thereby limiting a country's ability to raise its standard of living. Another problem is that the world price of primary goods fluctuates in the short-term. Prices of primary goods are mainly determined by the world supply of them. Producers are price takers with very little influence over price.

The quantity of primary goods supplied is not very responsive to changes in price. For example, a farmer decides which crops to grow a long time before the goods come to market. It takes a long time to move **resources** away from the production of one crop to the production of another. It is not possible to change the quantity supplied in the short term, therefore supply of agricultural goods is **price inelastic**. Supply of

manufactured goods are likely to be more **price elastic** than agricultural goods because it is easier for firms producing manufactured goods to reallocate their factors to different production processes and thereby increase output. And because there are few, if any, **substitutes** for some primary goods **price elasticity of demand** tends to be inelastic.

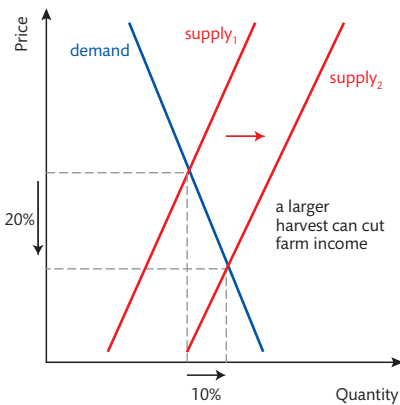


Figure 82.4

As incomes fall, farmers in developing countries try to increase supply in order to increase income. This can have the effect of reducing price even further. Land becomes over used, leading to soil **degradation** and negatively affecting **productivity**, harming the opportunities of future generations to earn income from the land.

**Model sentence:** Increases in productivity in the agricultural industry lead to increases in the world supply of agricultural products and a fall in price.

## Why is the inability to access international markets a barrier to economic development?

The World Bank's 2009 World Development Report highlighted how important market access is to a country's economic development. Countries that are **landlocked** have a major disadvantage. It is more difficult for them to access overseas markets. For example, landlocked African countries have particularly low levels of economic development. Niger, Chad, Mali, and the Central African Republic are landlocked African countries and have amongst the lowest HDI in the world, all being under 0.36. Poor countries lack the investment needed to improve cross-border **transport infrastructure** making it costly and very difficult to get their goods to foreign markets. And lack of cooperation between neighbouring countries makes it more difficult for landlocked countries to gain access to international markets.

Governments throughout the world protect their domestic producers of primary goods from international trade restricting developing countries, access to foreign markets. **Protectionist policies** include **tariffs**, **quotas**, and **subsidies** to domestic producers along with non-price restrictions such as **technical trade barriers**. For example, the EU subsidizes the production of some agricultural output which acts as an incentive for European farmers to increase supply, pushing down the world price, thereby reducing the income of producers in developing countries. Some of the excess supply is dumped in developing countries at below cost prices, harming domestic producers. Such policies stop farmers in developing countries from benefiting from the **comparative advantage** they have in the production of such goods and reduce income earned from export revenues. Lack of income leads to low levels of investment leaving farmers in developing countries unable to raise productivity. (See pages 201–209 for a detailed discussion on the effects of trade protection on international trade.)

Discussed below are various ways by which economic growth and development can be achieved:

## How might import substitution industrialization (ISI) affect economic growth and development?

**Model sentence:** The aim of ISI is to encourage domestic producers to make goods that are currently being imported so that domestic consumers switch expenditure away from imports to domestically produced goods.

### Subject vocabulary

**price elastic** the percentage change in quantity demanded/supplied > the percentage change in price

**substitutes** a good that can be used in place of another good

**price elasticity of demand** a measure of how quantity demanded responds to a change in price in percentage terms

**producer revenue** the income a firm receives from consumers in exchange for goods (revenue = price × quantity sold)

**balance of trade** the difference between the monetary value of a country's exports and the monetary value of its imports

**productivity** the quantity of output per unit of input

**transport infrastructure** the physical capital that supports a transport system such as roads, railways, ports, airports

**protectionist policies** policies, such as tariffs and quotas, aimed at protecting domestic firms and industries from foreign competition

**tariffs** a tax placed on imported goods and services

**quotas** a physical limit placed on the number of goods that can be traded or produced

**subsidies** payments made by government to firms per unit of output

**technical trade barriers** things that may stop firms being able to export their goods into a country, e.g. technical regulations, minimum standards, certification for health and safety

**comparative advantage** when a country, firm, or individual is able to produce a particular good or service at a lower opportunity cost than other countries, firms, or individuals

### Glossary

**degradation** becoming worse in condition

**landlocked** a country that is surrounded by other countries

## Subject vocabulary

**average costs** is equal to total cost divided by quantity of output

**labour-intensive** describes production that requires a large amount of labour relative to the amount of capital

**infant industries** a new industry which often is not able to compete against established foreign industries and therefore needs to be protected from the competition through subsidies and tariffs

**technologically advanced capital** capital that incorporates new technology and is used in place of existing capital to produce goods and services thereby increasing productivity

**economies of scale** the fall in average cost in the long run brought about by an increase in the size of a firm's operation

**barriers to trade** restrictions imposed by a government on the free exchange of goods or services between countries

**raw materials** the basic material from which a good is made

**capital** (goods) manufactured goods that are used in the production of other goods

**export subsidies** payments made by a government to its exporting firms or industries per unit of the good exported

**exchange rate controls** restrictions imposed by the government of a country on the buying and selling of its currency for another

**comparative advantage** when a country, firm, or individual is able to produce a particular good or service at a lower opportunity cost than other countries, firms, or individuals

**GDP** gross domestic product is the monetary value of all the finished goods and services produced within a country in a given period of time, usually measured over a year

**human capital** this relates to the store of knowledge and the set of skills that a worker possesses which can be used in the production process. The higher the value of human capital the more productive the worker is. Human capital can be improved through investment in education and training.

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Infant domestic industries would find it difficult to compete against the large existing foreign firms who produce at relatively low **average costs**. Therefore, the government of a developing country protects its emerging manufacturing industries through tariffs and quotas placed on imported manufactured goods and through subsidies paid by the government to domestic producers.

Developing countries have a large surplus of low skilled labour and should therefore focus on developing industries that are **labour-intensive**. Such industries include the textile industry (clothes and shoes) and the drinks industry. These goods are in high demand in developing and developed countries.

However, the new emerging **infant industries** must compete against foreign firms that have been in business a long time producing for a very large market. Existing large firms are able to invest in **technologically advanced capital** and they benefit from **economies of scale**, leading to low average costs. Infant industries in developing countries are not able to compete on price against the more productive foreign firms, the government must therefore put up protectionist barriers against cheaper imports.

Given time the emerging industries can increase the size of their market and gain economies of scale and the skills necessary to compete internationally, so that the barriers to trade can be reduced or removed. However, owners of the protected industries put pressure on the government to keep the tariffs and, because the government gains tax revenue from tariffs, the **barriers to trade** often remain in place for the long term. Without competitive pressure, domestic producers have little incentive to become more productive.

Other countries may raise trade barriers against imports coming from the developing country in response to tariffs placed on their goods. This will reduce the export revenues earned from the developing country's existing exporting industries.

The domestic market in developing countries is relatively small and incomes are low, thereby restricting the level of demand for the goods. Therefore potential revenue and profit is limited. Domestic producers must try to sell their output on the international market. But to do this, firms must use the time that they are protected to increase productivity so they are able to compete internationally. It is possible that, even if productivity was increased, foreign countries in the developed world would raise barriers to trade against the developing country.

Developing countries hoped that ISI would reduce dependency on imported goods. However, industrialization increased the quantity of imported **raw materials** and **capital** goods needed for production in the newly created industries.

**Model sentence:** ISI led to increases in the amount of export revenue needed to buy the imports necessary for production but the output was for domestic consumption and therefore earned no export revenue.

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## How might export promotion affect economic growth and development?

Export promotion is a policy aimed at increasing a country's export revenue through introducing protectionist policies, such as **export subsidies** and **exchange rate controls**. The aim is to take full advantage of the **comparative advantage** a country has in the production of particular goods and to encourage domestic production of the goods for export, thereby increasing export revenue, domestic incomes, and economic growth. Government can also help firms in the export market by providing advice on which goods to produce and on identifying potential international markets in which to sell the goods.

The government of a developing country can make its exports more competitive by paying subsidies to domestic exporting industries. In effect this reduces costs of production, allowing the exporters to sell at a lower price. Government can also devalue the domestic currency, thereby making the exports more price competitive.

During the 1960s, Korea put in place a policy of export-led growth. At first the aim was to promote the export of goods from industries that were labour-intensive in order to take advantage of Korea's surplus of low cost and low skilled labour. Export growth mainly came from the clothes and footwear industries. Taiwan and Malaysia followed a similar policy. **GDP** increased, leading to an increase in savings and investment. Over time, through investment in **human capital** and **physical capital**, the countries experienced **long-run economic growth**. Exporting industries no longer needed to rely on low-cost, labour-intensive production methods. Through economic growth and investment the countries' exporters moved towards **capital-intensive** production and produced a greater variety of manufactured goods for the export market.

Governments of developing countries must achieve certain **macroeconomic objectives** in order to ensure international competitiveness. Most importantly, governments must keep inflation low and stable. High rates of inflation reduce price competitiveness, harming the export industries. The government must also ensure that the **exchange rate** is kept at a rate that makes exports price competitive.

When a high proportion of income in a country comes from the sale of exports the country's economy can become over-dependent on demand for their goods from the rest of the world. **Recessions** in other countries lead to a fall in demand for all goods in those countries, including the demand for imports. In a global recession demand for the developing country's exports falls, leading to a big fall in the flow of income into the country and a fall in GDP.

The developed countries also want to protect their domestic industries from foreign competition. Barriers to trade such as tariffs are put up in response to cheaper imports from developing countries, thereby reducing the export revenues of developing countries.

The success of decades of export-led growth in improving economic development in South Korea and Taiwan can be judged by the value of the countries' HDI. In 2013, South Korea's HDI was 0.909 and Taiwan's was 0.890. These are very similar to the HDIs of older developed countries such as the UK, France, and Italy.

## How might trade liberalization affect economic growth and development?

Trade liberalization is the reduction or removal of barriers to trade. Each developing country has a comparative advantage in the production of particular goods. That is, each country can produce a particular good at a lower opportunity cost than can other countries. If each country produces goods in which they have a comparative advantage, and then trades, more goods can be produced with the world's scarce resources thereby increasing economic welfare (see pages 196–201 for a detailed discussion on the benefits of free trade).

However, many developing countries have a comparative advantage in the production of **primary goods**. As explained earlier in this unit the prices of these goods fluctuate and are falling in the long term, leading to falling incomes. The advantage developing countries have in the production of manufactured goods comes from the surplus of low skilled workers that pushes labour costs down. In order to maintain this advantage wages in exporting industries must be kept low, leading to a low **standard of living** and high levels of poverty. Some economists argue that trade liberalization is encouraged by developed countries so that they can import cheap goods and thereby enjoy a higher standard of living at the expense of the low paid workers in developing countries. **Multi-national corporations** (MNCs) operating in developing countries also benefit from keeping wages low because it leads to higher profit. Some economists argue that trade liberalization benefits MNCs and buyers in developed countries but leads to increases in **relative poverty**, low wages, unequal distribution of income, and very poor working conditions in LDCs.

If a developing country removed its barriers to trade on imported goods the price of imports would fall, increasing buyers' **purchasing power**. But at the same time domestic producers would not be able to compete against cheaper imports, leading to a fall in demand for their goods and a rise in **demand-deficient unemployment**. The theory of comparative advantage says that developing countries should reallocate resources to the production of goods it can produce most efficiently. In the real world this is often not possible because factors of production are not perfectly mobile. In other words, it is often the case that factors used in one industry cannot be used in other industries. However, even if this is done, other countries can put up barriers to trade effectively eliminating the advantage.

The World Trade Organization encourages all countries to agree to the removal of barriers to trade whilst at the same time asking the developed world to consider the particular needs of developing countries. In particular, it encourages developed countries to remove agricultural subsidies and to stop **dumping**, and to allow imports of manufactured goods from LDCs free of tax and quotas in order to encourage industrialization and economic growth in LDCs.

**Model sentence:** The WTO's long-term aim is to encourage developed countries to put in place a set of agreements over trade that take into account the particular circumstances of developing countries, so that they are able to increase the size of their industrial sectors and reduce their dependence on the export revenue earned from the production of primary goods.

In the short term the WTO encourages regional trade agreements to increase economic integration. The WTO puts forward the view that free trade with neighbouring countries allows developing countries to gain from the benefits of trade liberalization (such as economies of scale) on a regional level amongst countries which have similar economic conditions without having to deal with the potential costs of trade liberalization with developed countries. See pages 238–42 for a detailed explanation of trade agreements and economic integration.

## Subject vocabulary

**physical capital** any manufactured good that is used in the production of other goods and services such as machinery and buildings

**long-run economic growth** an increase in the productive capacity of a country

**capital-intensive** describes production that requires a large amount of capital relative to the amount of labour

**macroeconomic objectives** the main aims of government macroeconomic policy, such as low and stable inflation, low levels of unemployment, and sustainable economic growth

**exchange rate** the price of a country's currency in terms of another currency

**recessions** two consecutive quarters of negative economic growth

**primary goods** a good that has not been processed and is in a raw state (e.g. fruit/wheat)

**standard of living** the level of well-being of a person or groups of people

**multi-national corporations** a corporation that operates in two or more countries

**relative poverty** a measure of poverty that relates to the average income earned in a country or region. Definitions vary but many governments define it as an income less than 50% of the median income.

**purchasing power** a measure of how many goods and services a given amount of money can buy

**demand-deficient unemployment** unemployment caused by a lack of aggregate demand. Unemployment changes as the economy goes through the business cycle, increasing when AD falls and decreasing when AD rises.

**dumping** the export by a country or firms of goods at a price that is lower than the cost of production



## Subject vocabulary

**terms of trade** the amount of imported goods a country can buy per unit of its exported goods

**price elasticity of supply** a measure of how quantity supplied responds to a change in price in percentage terms

**natural resources** assets, such as mineral deposits and timber, that occur in nature and can be used in production

**foreign direct investment** cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

**corporation taxes** a tax levied in the UK on company profits

**fiscal policy** government policy designed to achieve macroeconomic objectives through government expenditure and taxation

**inflation** an increase in the general level of prices of goods/services in an economy over a given time period, usually a year

**exchange rates** the price of a country's currency in terms of another currency

**productivity** the quantity of output per unit of input

**national output** the value of all goods and services produced in a country in a given period of time

**cycle of poverty** occurs in a country which has low income and therefore low levels of savings. Low levels of savings means little investment can take place and the economy is unable to grow, thus income remains low.

## Glossary

**diversification** the making of different products or getting involved in new business areas

**infrastructure** the basic structure/systems of a country (e.g. roads/railways)

## How might diversification affect economic growth and development?

The disadvantages of over-specialization have already been explained in this unit along with the advantages and disadvantages of export promotion and import substitution.

The global economic crisis and recession which began in 2008 has highlighted the structural weaknesses of many LDCs, particularly in Africa, which are dependent on export revenue from the sale of primary goods. Income flowing into an LDC is affected by world demand for primary goods. Global demand for primary goods decreased during the global recession, leading to a fall in price and deterioration in the **terms of trade**. Lower prices led to a fall in the export revenue of many LDCs and the fall in price from a fall in demand is relatively large because **price elasticity of supply** is inelastic. Also, extreme weather conditions in LDCs affect the supply of agricultural output leading to changes in supply and fluctuations in price.

Good governance is needed to create the economic conditions necessary for **diversification**. Government needs to ensure that **natural resources** are managed effectively and not over used. Investment in human capital will increase the skills and health of the labour force and thereby attract **foreign direct investment**. Further incentives, such as relatively low **corporation taxes** and a large surplus of low cost labour will also help to attract inward investment.

Governments can encourage trade on a regional basis by reaching trade agreements with neighbouring countries so that local producers can benefit from access to new, bigger markets and benefit from greater economies of scale.

**Fiscal policy** must be used to keep **inflation** at a low and stable level so that exports remain price competitive.

**Exchange rates** must be low enough to ensure emerging exporting industries are competitive and the government must direct investment into improving the country's **infrastructure**, in particular transport and communication infrastructure, so that industries are able to access markets efficiently.

Diversification means that a country becomes less dependent on the sale of its primary goods for its income. Over time, through industrialization, GDP rises allowing more income to be saved. Increases in investment in human and physical capital lead to increases in **productivity** and **national output**. Government gains more tax revenue and can target spending on improving educational attainment and health services thereby increasing economic development and the country's HDI. In this way a country can break the **cycle of poverty**.

For some countries, particularly African landlocked countries such as Chad, Mali, and Niger, the prospects for diversification and economic development are not good. Many countries do not have the legal infrastructure or good governance necessary for economic development. Many politicians are only interested in gaining and holding onto power in order to make themselves and their friends and families rich. Many do not have to be re-elected and even when there are elections the outcome is fixed. Focus must be on responsible governance, creating the legal and financial infrastructure necessary for long-run economic growth and development.

### Test your understanding of this unit by answering the following questions

- Distinguish between import substitution and export promotion.
- Explain why the price of primary goods is volatile.
- Explain how over-specialization on the production of primary goods affects a developing country's economic development.